

## Internal Revenue Service

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### LEGEND:

Taxpayer =

Buyer =

State =

Date X =

Date Y =

Date Z =

X =

Commission =

Order =

Director =

Dear :

This letter responds to the request, dated February 6, 2009, filed on behalf of Taxpayer for a ruling on the normalization effects, under former § 46(f) of the Internal Revenue Code, of the treatment proposed by Commission in Order on the unamortized balance of Taxpayer's Accumulated Deferred Investment Tax Credit (ADITC) with respect to assets transferred to Buyer.

The representations set out in your letter follow.

Until Date X, Taxpayer was an integrated electric and natural gas utility, operating both an integrated electric utility business and a natural gas transmission and distribution business in State. The natural gas business is subject to regulation by Commission. Commission determines rates for utilities, including the natural gas business at issue here, using traditional “rate of return” regulation. The assets of the natural gas business are “public utility property” within the meaning of §§ 168(i)(10) and 46(f)(2). Taxpayer timely elected, under § 46(f)(2), to ratably flow-through Investment Tax Credit (ITC) on public utility property as a cost of service reduction. As of Date Y, the unamortized ADITC on the Taxpayer’s books of account relating to the gas business assets is approximately \$X.

Effective Date X, Taxpayer sold to Buyer all of the assets of its natural gas business in a taxable asset sale. A stipulation; signed by Taxpayer, Buyer, Commission staff, and intervenors; was filed with Commission detailing certain terms of the sale. In pertinent part, the stipulation provided that the Taxpayer would not receive stranded cost recovery from ratepayers and would not return any gain on the sale of the assets to ratepayers, that the Buyer would freeze gas base rates at the level previously approved by Commission for a period of not less than three years after the sale, that no ADITC or Accumulated Deferred Federal Income Taxes (ADFIT) would be transferred to Buyer.

After testimony and various submissions to Commission, on Date Z, Commission issued Order, partially approving the stipulation. The Commission first recognized that a transfer of the entire ADITC balance from Taxpayer to Buyer as part of the sale of the natural gas assets would violate the normalization rules. However, Commission required that, commencing on the date that new rates for the customers of Buyer become effective, Taxpayer will be required to transfer the balance of its then-existing ADITC over the same period and in the same amounts as if Taxpayer had not transferred the natural gas assets to Buyer, provided that such transfer would not be a normalization violation or, in the alternative, that the adverse impact on Taxpayer’s electric or gas customers would be less than the amount of ADITC transferred. Taxpayer was also required to file this request for a ruling to determine whether the transfer ordered by Commission constituted a normalization violation. Thus, Taxpayer has requested that the Service issue the following rulings:

1. A direct flow-through, by Taxpayer to customers, of the ADITC balance on the natural gas assets subsequent to the sale of those assets to Buyer violates the normalization requirements of former § 46(f)(2)(A) and § 1.46(k)(2)(ii) of the Income Tax Regulations.
2. A transfer from Taxpayer to Buyer of the Taxpayer’s unamortized ADITC balance in a taxable sale of assets and the use thereof by the Buyer to reduce its cost of service violates the normalization requirements of former § 46(f)(2)(A).

3. Taxpayer's remittance to Buyer of amounts in lieu of and equal to the amount of Taxpayer's annual ADITC amortization if the sale of assets had not occurred for the purpose of flowing-through those amounts to the ratepayers of Buyer as ordered by Commission violates the normalization requirements of former § 46(f)(2)(A).
4. If a normalization violation occurs, the result under former § 46(f)(4) would be the disallowance or recapture of all of the unamortized investment tax credit of Taxpayer with respect to public utility property under the jurisdiction of Commission.

### Conclusions

1. A direct flow-through, by Taxpayer to customers, of the ADITC balance on the natural gas assets subsequent to the sale of those assets to Buyer violates the normalization requirements of former § 46(f)(2)(A) and § 1.46(k)(2)(ii) of the Income Tax Regulations.
2. A transfer from Taxpayer to Buyer of the Taxpayer's unamortized ADITC balance in a taxable sale of assets and the use thereof by the Buyer to reduce its cost of service violates the normalization requirements of former § 46(f)(2)(A).
3. Taxpayer's remittance to Buyer of amounts in lieu of and equal to the amount of Taxpayer's annual ADITC amortization if the sale of assets had not occurred for the purpose of flowing-through those amounts to the ratepayers of Buyer as ordered by Commission violates the normalization requirements of former § 46(f)(2)(A).
4. If a normalization violation occurs, the result under former § 46(f)(4) would be the disallowance or recapture of all of the unamortized investment tax credits of Taxpayer with respect to public utility property. Further, if the amount of Taxpayer's unamortized credits or credits not previously restored to rate base for such property (whether or not for open years) exceeds the credits for open years described above, the taxpayer's tax for the taxable year of the violation is increased by the larger amount.

### Law and Analysis

#### Issues 1-3 – Determination of Whether a Normalization Violation Will Occur Under Order

In general, the ITC was introduced in 1962 and repealed for years after 1985 by the Tax Reform Act of 1986. Former section 46(f) of the Code provides an election for

ratable flow through under which an elector may flow through the investment tax credit to cost of service. However, former 46(f)(2)(A) provides that no investment tax credit is available if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit determined under former 46(a) and allowable by section 38. Also, under former section 46(f)(2)(B) no investment tax credit is available if the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit determined under former 46(a) and allowable by section 38.

Former § 46(c)(3)(B) defines public utility property to include property used in the trade or business of furnishing or sale of gas through a local distribution system if the rates for such furnishing or sale have been established or approved by a public utility commission or similar body.

Former § 46(f)(6) of the Code provides that for purposes of determining ratable portions under former § 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Under section 1.46-6(g)(2) of the regulations, "ratable" for purposes of former section 46(f)(2) of the Code is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. Regulated depreciation expense is the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes. Such period of time shall be expressed in units of years (or shorter periods), units of production, or machine hours and shall be determined in accordance with the individual useful life or composite (or other group asset) account system actually used in computing the taxpayer's regulated expense. A method of reducing is ratable if the amount to reduce cost of service is allocated ratable in proportion to the number of such units. Thus, for example, assume that the regulated depreciation expense is computed under the straight line method by applying a composite annual percentage rate to original cost (as defined for purposes of computing depreciation expense). If cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing depreciation expense beginning with a particular accounting period, the computation of ratable portion must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals.

The method prescribed by section 1.46-6(g)(2) of the regulations for determining whether the taxpayer's cost of service for ratemaking is reduced by more than a ratable portion of the investment tax credit depends upon correlating the credit with the

regulatory depreciable useful life actually used for the property that generated the credit. That the correlation must remain constant and current is illustrated by the requirement that the ratable portion must be adjusted to reflect correspondingly any revision to the composite annual percentage rate applied for purposes of computing regulated depreciation expense.

Section 1.46-6(b)(2)(i)(A) defines “cost of service” as the amount required by a taxpayer to provide regulated goods or services. Cost of service includes operating expenses, maintenance expenses, depreciation expenses, tax expenses, and interest expenses. Section 1.46-6(b)(2)(ii) provides that, in determining whether, or to what extent, a credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service. Examples of such treatment include reducing by all or a portion of the credit the amount of Federal income tax expense taken into account for ratemaking purposes and reducing the depreciable basis of the property by all or a portion of the credit for ratemaking purposes.

Section 1.46-6(b)(4) makes clear that cost of service or rate base is considered to have been reduced by reason of all or a portion of a credit if such reduction is done in an indirect manner. Section 1.46-6(b)(4)(iii) provides that a type of indirect reduction is any ratemaking decision intended to achieve an effect similar to a direct reduction to cost of service or rate base. In determining whether a ratemaking decision is intended to achieve this effect, consideration is given to all the relevant facts and circumstances, including the record of the proceeding, the regulatory body’s orders, and the anticipated effect of the ratemaking decision on the cost of service or rate base.

Section 1.46-6(k) provides rules for the application of former § 46(f)(1) and (2) with respect to public utility property which ceases to be public utility property, whether by disposition, deregulation, or otherwise (deregulated public utility property) in the hands of the taxpayer.

Section 1.46-6(k)(2) permits a utility whose assets cease to be public utility property in its hands to return to its ratepayers the normalization reserve for EDFIT with respect to those assets and, in certain circumstances, also permit the return of part or all of the reserve for ADITC with respect to those assets.

In this case, Taxpayer has transferred the assets that generated the investment tax credit in a taxable sale of assets. In Order, Commission seeks to provide to ratepayers the benefits of the unamortized ADITC, directly or indirectly, if such is not in violation of the normalization rules. In a taxable sale of assets, the purchaser does not “step into the shoes” of the seller and as a result, any unamortized ADITC associated with the assets do not carryover from the seller to the purchaser. Instead, the purchaser receives the benefit of a new tax basis in, and a new placed in service date for, the property. This new basis and placed in service date determine the availability and the amount of the investment credit as well as any other benefits, such as

accelerated depreciation, that the purchaser may claim for the acquired property. Because the acquired assets were placed in service by Buyer after 1985, Buyer is not entitled to claim the investment credit for the acquired assets. Thus for the acquired property, there is no investment credit claimed by Buyer to reduce the cost of service under former § 46(f)(2). Buyer thus has no investment credit with respect to the acquired assets and, because Buyer does not “step into the shoes” of Taxpayer, the accumulated but unamortized ADITC does not follow the property to Buyer.

The normalization rules under former § 46(f) contemplate that the utility may claim the investment credit for public utility property. Further, the legislative purpose underlying former § 46(f) is to provide capital for investment in new equipment. If the ADITC's related to Taxpayer's public utility property are ratably flowed through to cost of service, Buyer would be flowing through to its customers an investment credit that is not available to, and was not claimed by, Buyer. Consequently, Buyer would receive no tax benefits of the investment credit while its customers would. Accordingly, any adjustment to cost of service for the ADITC's of Taxpayer would not be consistent with the purposes of former § 46(f).

Under certain circumstances, as described in § 1.46-6(k), some or all of ADITC may be available for flow-through to ratepayers even where the assets are no longer public utility property in the hands of a taxpayer. However, where there is a taxable sale and the assets are public utility property in the hands of a transferee, those regulations do not allow flow through of the ADITC because the transferee, rather than the transferor, is recovering the cost of the property through ratemaking depreciation and such ratemaking depreciation is based on the basis of the assets in the hands of Buyer, not Taxpayer. Consequently, no portion of the unamortized ADITC remaining at the date of sale may be used to directly or indirectly reduce Taxpayer's cost of service. Under § 1.46-6(b)(4), it is clear that a commission cannot achieve indirectly the accounting equivalent of a pass-through of ADITC where the direct pass-through is not permitted.

Thus, Taxpayer will violate the requirements of the investment tax credit normalization rules set forth in former section 46(f), if it directly or indirectly passes the unamortized balance of the ADITC balance associated with the gas business assets sold to Buyer.

#### Issue 4 – Sanctions for Normalization Violation

Section 1.46-6(f)(4) provides that the ITC is disallowed for any section 46(f) property placed in service by a taxpayer before the date a final decision of a regulatory body that is inconsistent with section 1.46-6(f)(2) is put into effect on or after such date and before the date a subsequent decision consistent with section 1.46-6(f)(2) is put into effect.

Section 1.46-6(f)(2) provides that there is no disallowance of a credit before the first final inconsistent determination is put into effect for the taxpayer's § 46(f) property.

Section 1.46-6(f)(8)(1) provides that "inconsistent" refers to a determination that is inconsistent with § 46(f)(1) or (2). For example, a determination to reduce the taxpayer's cost of service by more than a ratable portion of the credit would be a determination that is inconsistent with § 46(f)(2).

Senate Report No. 94-36, 94th Cong., 1<sup>st</sup> Sess. 44-45 (1975), 1975-1 C.B. 590, 610, provides, in its explanation of the ratemaking treatment to be accorded the additional ITC allowed public utilities under the 1975 Act, explains that the additional ITC is to be disallowed if the regulatory agency requires the flowing-through of a company's additional ITC at a rate faster than permitted, or insists upon a greater rate base adjustment than is permitted, but only after a final determination is put into effect. That report further provides that the rules provided under existing law with respect to determinations made by a regulatory body and the finality of its orders would apply to this provision.

Senate Report No. 92-437, 92<sup>nd</sup> Cong., 1<sup>st</sup> Sess. 40-41 (1971), 1972-2 C.B. 559, 581, provides, in its explanation of amendments to the Revenue Act of 1971 dealing with the limitations on the ratemaking treatment of the ITC under section 46(e)(1) and (e)(2), that the Committee hopes that the sanctions of disallowance of the ITC will not have to be imposed.

The ITC was repealed in the Tax Reform Act of 1986 (the Act), effective generally for property placed in service after 1985. While the ITC was repealed, the Act clarified and increased the sanctions imposed for a normalization violation with respect to the ITC. Section 211(b) of the Act provides that, if a taxpayer fails to meet the normalization requirements for the ITC with respect to any public utility property in any year ending after December 31, 1985, all credits for tax years open under the statute of limitations at the time a final determination is rendered inconsistent with normalization requirements are recaptured. Further, if the amount of the taxpayer's unamortized credits or credits not previously restored to rate base for such property (whether or not for open years) exceeds the credits for open years described above, the taxpayer's tax for the taxable year of the violation is increased by the larger amount.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your

authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman  
Senior Technican Reviewer, Branch 6  
(Passthroughs & Special Industries)

cc: